708 The Evolving Role of Audit Committees in Corporate Governance

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Faculty Biographies

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Theodore S. Boone is an assistant general counsel at Ernst & Young LLP.

Mr. Boone is a co-chair of the corporate and securities committee of the Washington DC Area Chapter. He is a member of the New York and Washington, DC bars.

Mr. Boone received a B.A. from the University of Illinois at Champaign-Urbana and his J.D. from Columbia University Law School.

Kayla J. Gillan

Kayla J. Gillan is one of four founding members of the Public Company Accounting Board (PCAOB), an organization created by the landmark Sarbanes-Oxley Act of 2002 and charged with reforming the way in which public companies are audited. Since her appointment in October 2002, Ms. Gillan has led several board initiatives, including the PCAOB's forums on auditing in the small business environment and creation of the PCAOB's standing advisory group.

Prior to her appointment to this board, Ms. Gillan worked in the pension field for over 16 years, specializing in trust, securities, governance, administrative, policy, and operational matters. Ms. Gillan served for 6 years as general counsel to the $180 billion California public employees' retirement system (CalPERS) and for 10 years in other positions, including deputy general counsel.

She has published and been a frequent speaker on subjects including the role of the independent auditor, investing in the global community, and corporate governance.

Ms. Gillan received her law degree from the University of California at Davis.

Donald T. Nicolaisen

Donald T. Nicolaisen is the chief accountant of the U.S. Securities and Exchange Commission (SEC) in Washington, DC. The chief accountant serves as the principal advisor to the commission on accounting and auditing matters, and is responsible for formulating and administering the accounting program and policies of the commission.

Prior to joining the SEC, Mr. Nicolaisen was a senior partner at PricewaterhouseCoopers. He began his career at the firm's predecessor, Price Waterhouse and he is a certified public accountant. Mr. Nicolaisen served on both the firm's U.S. and global boards, led Price Waterhouse's national office for accounting and SEC services, and was the engagement and global relationship partner for several of that firm's largest clients. Previously, Mr. Nicolaisen was also Price Waterhouse's representative on the Financial Accounting Standards Board's emerging issues task force.

Mr. Nicolaisen received his B.A. from the University of Wisconsin, Whitewater.

Speech by SEC Staff: Remarks before the 2004 AICPA National Conference on Current SEC and PCAOB Developments

by

Donald T. Nicolaisen

Chief Accountant, Office of the Chief Accountant
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Washington, D.C.
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Introduction

Thank you for that kind introduction and good morning. As we kick-off the AICPA's Thirty-Second National Conference on Current SEC and PCAOB Developments, let me begin by thanking the conference staff who - we all know - have worked hard to pull this event together. The AICPA has long played a critical role in providing quality continuing education programs to its members through conferences such as this one. I understand that we have a record number of attendees. So welcome to the newcomers and to those of you, like me, who have been attending this conference for many years. Also I am pleased to see so many young faces in the audience. You are the future of our profession, and you will inherit the legacy that prior generations leave behind, experience first-hand the reforms currently under way, and move forward the initiatives we dream today. So the comments I make, especially about the state of our profession, may have the most significant impact on you. This is a great time to be in the early stages of your career. You will have the opportunity to see the benefits of the recent reforms over the next decades and to push for further improvements. I urge you to be involved, get your peers involved, embrace change and make this profession the gold standard - one that is known for constantly raising the bar and exceeding expectations. What you do matters a great deal.

I should also mention here that the remarks I make today are my own and do not necessarily represent the views of the Commission or others of its staff. And I'll take this opportunity to extend the disclaimer to include all the SEC staff speaking at this conference.

Based on the agenda, I think it's safe to say that this will be an interesting couple of days. And I hope you take advantage of the Q&A sessions. This morning - following my comments - you will hear from my three exceptionally talented Deputies: Scott Taub who has done double and triple duty in the past is now focusing more of his time and energy on accounting and registrant matters, Andrew Bailey who oversees auditing matters and, the newest member of my team, Julie Erhardt who will involve herself in international activities. Because of the tight schedule, I suspect that we will not get to all of your questions. So I encourage you to approach us during the breaks or in the hallways. This process of give and take allows us to better understand what is important to you.

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Speaking of the staff, we also have a number of other SEC staff who will be covering numerous issues in greater detail over the next two days. I would recommend that you listen carefully and don't hesitate to ask them questions, because these are the issues that we will be focusing on in the near term. We are in a time of change, and it is important that all participants engage in this dialogue as we consider short, medium and long term improvements to our profession, to financial reporting, and to the standard setting process.

My comments today will be broad-ranging, covering - among other things - the state of the accounting and auditing profession, enhancing the financial reporting process, off-balance sheet arrangements, reporting on internal controls, the use of new risk management and technology tools, and international activities. With that in mind, let me point out a unifying theme in all matters handled by my office. First, we need to provide better and more useful information to the investing public. Second, we need to provide more timely information to investors. And third, we need to provide this information in a cost-effective manner. To achieve these goals, I will work closely with investors, analysts, preparers, and auditors as well as other governmental agencies and standard-setters. I've been around too long to expect perfection, but I do hope that you embrace change and be engaged as the profession raises the bar.

Before I speak about these issues, I'd like to make a few comments about the changes that we have made in OCA during the last year. In your dealings with us, you may have noticed that we are more proactive and delving into the issues more deeply. That's true in large part because, during the last year, the office has been completely restructured, more than doubled in size, and we have streamlined communications between OCA and other Divisions within the Commission. These changes enable us to take on additional responsibility, such as oversight of the PCAOB. We are now more proactive in a number of areas including accounting and auditing matters, considering and testing the use of new technology and risk management tools, and getting out in front of issues. Much of this is due to the great talent that exists in my office as well as other areas of the Commission. I would also be remiss in not commending the companies and accounting firms that have brought accounting and auditing issues to our attention, early in the process. So let me say, thank you to the SEC staff, and thank you to those in the profession who, over the last year, have actively worked with us on accounting and auditing developments.

State of the Accounting and Auditing Profession

An important part of my job - and the job of others of the SEC staff - is to enforce our nation's accounting standards and to help ensure that the millions of investors who invest in our capital markets can make investment decisions on the basis of timely, relevant, reliable and complete information. Investor protection forms the bedrock of the decisions that I make. I also understand that with this responsibility comes accountability. You know that I hold preparers, auditors, standard setters, my staff and others to a very high standard, but I want you to know that, as Chief Accountant, I also have high expectations of myself and recognize that I have a unique position of responsibility and accountability.

I joined the Commission, in large part, because I thought that I could make a contribution to the future of our profession. I had a 100-day plan, a one-year plan and so forth. Over the last year many of the goals I set for myself have been met, but some have not. This was a result of a number of factors, including the need to give preparers and auditors some breathing room to implement new requirements, such as the internal control requirements. But, in the final analysis, I am accountable to the investing public, the Commission, and to those of you in this audience, and my performance will be judged accordingly.

I spoke last year about my disappointment with cooked books, indefensible audit and corporate governance failures, and intentional gaming of the accounting rules, which led to financial losses measured in the trillions and an inevitable crisis of investor confidence. The crisis was real. The losses were real. And every person in this room has been impacted by the resulting legislation - the Sarbanes-Oxley Act - in a very tangible way. I believe that the Act and the actions which followed are the most significant reforms affecting our capital markets since the Securities Exchange Act of 1934. The actions we take today and the manner in which we establish and execute our priorities, will be judged by future generations. I know that we all want history to report that we were successful in implementing change.

Sarbanes-Oxley established an appropriate foundation to improve financial reporting and, over the last year, key requirements have taken hold including:

- CEO and CFO certifications;
- Issuance of the first PCAOB inspection reports on the large firms;
- Issuance of important auditing standards by the PCAOB; and
- Soon, for the first time, public reporting on internal controls and their effectiveness - by both management and auditors.

There has also been a heightened concern for and a corresponding strengthening in corporate governance. This represents a tremendous amount of change. And it's important that we recognize the many market participants - many of you who are sitting in this room - who have worked tirelessly and diligently over the last few years to improve our systems and to regain investor confidence. To a large extent, I believe we are making progress. All across corporate America significant, additional resources have been added, training and continuing education has appropriately focused both on ethics and technical issues, awareness of corporate controls has transcended accounting and moved to all aspects of companies' operations, and there is a real push starting at the very top of business organizations to make the tough calls and to get the numbers right. These are all positive developments, and they should be acknowledged.

I also recognize that we continue to discover both industry-wide and company specific failures of business ethics and of disclosures to shareholders. Such failures are, of course, offensive and unacceptable. And they highlight the fact that, while we may have turned the corner, our profession's work is not yet done. Investors continue to be skeptical of management and auditor reports, and this prolonged erosion in investor confidence remains troubling. Investors and the public rightly demand more - holding management, board members, accountants, lawyers, standard-setters, regulators and others to higher standards, and they are still looking for greater quality and transparency in financial reporting. So while I am

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encouraged by the positive steps you have taken to regain investor confidence - and I mean that sincerely - I believe there is still much we can do.

In asking that all involved in financial reporting do more, I recognize that there already is a legitimate concern with overload. Significant costs have been incurred, the hours have been long, many of you have made huge sacrifices, and there are still resource constraints - at least in the short term - that are very real. I am sensitive to these issues and particularly to what can be a disproportionate cost burden with respect to smaller public companies. Small business is the growth engine of our economy, and we need to be careful that we do not create a regulatory framework that is so burdensome that it smothers the economic viability of these companies.

Speaking more specifically to auditors, I realize that over the last few years your profession has been under a great deal of scrutiny. That scrutiny and much of the criticism was warranted. Change was necessary, but it is important that this focus produce positive developments - developments that enhance the quality of the audit and help restore the credibility of the profession and its role as a leader in the financial community. As I said before, what you do does matter. I understand that your audit and business practices have undergone significant change. You now report to the audit committee. You are working long hours. You are under an enormous amount of pressure, and there is great concern about being second guessed. I appreciate your efforts, and I understand the anxiety, especially as you take on new responsibilities such as reporting on internal controls. You are making real progress.

That being said, I would encourage you to continue taking steps to enhance the credibility of your profession.

- Focus on your core business - the audit.
- Be open and transparent. Investors want to know more about your firms.
- Continue to instill a culture of ethics and integrity.
- Reward technical competence.
- And continue to play a public leadership role in our capital markets.

I am committed to supporting your efforts in these areas, and you will hear me speak more about this in the coming months. So I encourage you to engage in an open dialogue with all relevant participants, including the press.

Financial Reporting Process

I also believe that the financial reporting process can be greatly improved and better serve the needs of the investing public. Financial reporting is first and foremost a communication exercise, and it is broader than just the financial statements and the footnotes required by GAAP. It includes various disclosures in filings with the SEC, including MD&A, key performance indicators and other appropriate non GAAP measures and disclosures. These disclosures are essential to an understanding of financial performance, especially as we struggle with the complexities of a mixed attribute accounting model that uses a combination of historical costs, lower of cost or market, and fair values. All too often disclosures fail to provide sufficient information to investors about current, past or expected future changes, and they are often lacking in quality and organization. I encourage those preparing and auditing financial statements to think of disclosure rules as the floor, not the ceiling. I support the joint effort of the FASB and IASB on financial performance reporting. With the current mixed attribute model which allows assets and liabilities to be reported using different measurement attributes, it's important that investors have access to information that permits them to distinguish between balance sheet items that are a result of transactions verses those that lead to a change in value but do not involve transactions.

We live in a world where risk exposures are often selected, rather than inherent to the preparer's business model or industry. Disclosures should inform investors about the relationship between risk exposures and firm performance. Without this information, the predictive value of financial reports is less effective. Furthermore, many companies' disclosures can be better organized and presented. The good news is that management can significantly improve disclosures - and there is time to do it now - avoiding the need for more rules and enforcement. Let me repeat. As preparers, you can enhance the quality of communications with investors without the need for more rules.

My time is limited, so I'm going to speak only briefly about a few key areas that I believe would greatly enhance disclosure. Some of these issues will be discussed in greater detail by Scott Taub and by others during the upcoming panel sessions.

But, before I address these issues, let me respond to a question that many people have asked me: "When you refer to investors, who do you have in mind?" My response is this. They are real people - mothers, fathers, grandparents, brothers, sisters, friends, neighbors, blue collar workers, small business owners, employees with 401k plans, mutual fund owners, and professionals like you. You get the idea. These are the people who depend on what you do. They want to trust you and believe in what you say. These are also the people for whom you prepare financial statements, footnotes and related disclosures.

- You need to communicate with them in plain English. This should not simply be viewed as a compliance activity, but rather as a way to explain your business. For example, many users ask for information on the cash flow statement under the direct method, additional segment information, and disclosure beyond what is required by GAAP. There's nothing that stops companies from providing that information right now, and I suspect that improved disclosures would be rewarded by the capital markets.
- MD&A is the vital communication link between management and investors. Unfortunately the MD&A sections of some companies' reports continue to rely too much on boilerplate language at the expense of what are likely to be the more important and relevant disclosures for investors. There's no need to regurgitate the boilerplate language of the past. I would encourage preparers to take a user-focused approach to disclosure, providing a complete picture written in plain English.

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- We need to broaden investor understanding of what information is important in terms of making investment decisions. A clue: it's more than earnings-per-share. So I would ask you to reflect on the type of information you require before you, your company or your firm makes a major investment decision. Do you make similar information readily available and unvarnished to the public?

- I know that FIN 46 generated a great deal of discussion and concern, and many people have asked me in the last year whether it worked. The standard was on an accelerated track as a result of the concerns around SPEs raised by the Enron debacle. FIN 46 attempted to - and has generally been successful in - addressing an important aspect of consolidation practice, but it also raises the question as to whether there is a need to re-look at consolidation more generally. Our pending SEC report to Congress on off-balance sheet activities will cover this issue, as well as a number of other important topics such as accounting for leasing transactions, pensions, contingencies, and contractual obligations to name a few. So stay tuned.

The Standard Setting Process

Over the next year, we will be taking a hard look at many of our rules - including reporting on internal controls - and the manner in which they have been applied. In many instances, our goal will be to:

- You need to communicate with them in plain English. This should not simply be viewed as a compliance activity, but rather as a way to explain your business. For example, many users ask for information on the cash flow statement under the direct method, additional segment information, and disclosure beyond what is required by GAAP. There's nothing that stops companies from providing that information right now, and I suspect that improved disclosures would be rewarded by the capital markets.

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While I'm not going to speak extensively about this today, I did want to say a few words about off-balance sheet transactions. I know that FIN 46 generated a great deal of discussion and concern, and many people have asked me in the last year whether it worked. The standard was on an accelerated track as a result of the concerns around SPEs raised by the Enron debacle. FIN 46 attempted to - and has generally been successful in - addressing an important aspect of consolidation practice, but it also raises the question as to whether there is a need to re-look at consolidation more generally. Our pending SEC report to Congress on off-balance sheet activities will cover this issue, as well as a number of other important topics such as accounting for leasing transactions, pensions, contingencies, and contractual obligations to name a few. So stay tuned.

The Standard Setting Process

Over the next year, we will be taking a hard look at many of our rules - including reporting on internal controls - and in particular the manner in which they have been interpreted and applied. In many instances, our goal will be to:

- Provide additional guidance;
- Identify best practices;
- Streamline the process; and
- Ensure that our rules provide relevant and timely information to investors in a cost effective manner.

With respect to any new rules, we will follow an open process, appropriate transition periods will be provided, and every attempt will be made to ensure that the rules are operational. And I expect that the FASB and the PCAOB will do likewise. We are operating in a new environment, and we need to better define and establish priorities. A key aspect of this will be to find an appropriate balance between the quest for perfection and a common sense approach to standard setting.

Standards should focus more on the underlying objective of the accounting addressed and include few, if any, exceptions. With respect to auditing standards, the PCAOB is developing its agenda. And, as with the FASB, the PCAOB has some tough issues to consider. For example, there has long been a significant gap between investors' expectations and the auditor's responsibility to detect fraud. The trick will be to strike the right balance between investor education and cost effective auditing. This will not be easy, and I suspect that with approximately 90 million Americans investing in our markets, the gap will need to be closed, in large part, by addressing the auditor's ability and responsibility to detect fraud, and by explaining that role in terms that are understandable to investors.

With respect to accounting standards, similar transactions should receive similar accounting. The level of complexity in certain standards, such as in the areas of pension and derivatives accounting, needs to be addressed. Following an objective based approach to standard setting should eliminate many of these issues and result in more understandable standards. New standards will not be easy as the issues that remain unresolved are all complex.

I also encourage the FASB to think outside of the box. It's important that users, preparers, auditors and others be engaged and supportive of this process as the

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FASB tackles the more challenging issues. Revenue recognition is a prime example. I've heard Mike Crooch claim that revenue recognition appears in close to two hundred different pieces of accounting literature. And, of course, these pieces of literature include many nuances, some of which are unique to particular transactions. Revenue recognition is a leading contributor to restatements, enforcement actions and embarrassment to management and auditors. The FASB's initiatives in this area are an important step forward to eventually reaching a better outcome. I don't expect change overnight, but I would be disappointed if we didn't begin the journey. Before turning to the next topic, I'd like to make one more point on accounting standard setting. It's important that registrants have sufficient time to put in place internal controls before a new standard becomes effective.

Internal Control Reporting

Speaking of internal control processes, I believe that, of all the reforms contained in the Sarbanes-Oxley Act, getting these processes right may have the greatest impact on improving the accuracy and reliability of financial reporting. It is also what I consider to be the most urgent financial reporting challenge facing a large share of corporate America and the audit profession between now and certainly through much of 2005.

Investors expect companies to have strong processes and internal controls in place to ensure that financial information reported by management has integrity. This is so important that Alan Beller and I have worked together closely over the last year to monitor progress and advise the Commission regarding actions we considered appropriate. We have deferred certain initiatives, at least temporarily, to ensure that management and auditors put the appropriate emphasis on these requirements and to improve the chances of getting them right the first time around. We have supported the deferral of reporting deadlines to provide registrants and auditors with sufficient time. And, most recently, the Commission authorized a limited and temporary postponement of the filing date for smaller accelerated filers' management reports on internal controls. Based on discussions with audit firms and registrants, I believe that these actions should give the vast majority of registrants and auditors sufficient time to complete the work necessary to issue their reports on internal control. This is a major change in practice and, although the internal control requirements will not eliminate all fraud, they play an important role in strengthening financial reporting. Stronger internal controls should reduce the number of situations where a restatement results from weak control processes over financial reporting.

Many have asked whether these changes are worth the effort and cost. My reaction is that given the massive financial scandals, the decline in market capitalization and the resulting loss of investor confidence in our markets, I believe that the additional attention to controls is warranted. The increased attention is important because our capital markets run on faith and trust that the vast majority of companies present reliable and complete financial data for investment and policy decision-making. Being able to represent that an appropriate control system is in place strengthens public confidence and encourages investment in our nation's industries. And, I expect that management, including many of you in this audience, will sleep better knowing that your company has strong internal control processes.

In principle I believe that all companies who access our public markets should adhere to the same disclosure standards and, to the extent that they have like transactions, to account for them consistently. However, I recognize that the burden on smaller companies can be disproportionately higher and the cost/benefit of compliance needs to be appropriately weighed as we determine the best ways to protect investors. Clearly, one size does not fit all. I also recognize that our foreign private issuers face significant challenges and resource constraints over the next year as they move to IAS.

Though the Sarbanes-Oxley Act does not provide an exemption for foreign private issuers, we have and continue to be sensitive to the need to accommodate unique foreign structures and requirements. Throughout this process, we will continue to reach out and engage in an open dialogue. Clearly many non-U.S. issuers and their auditors are working hard and are well on their way to completing the work necessary to report on internal controls. However, I am sensitive that this requires in some cases great cultural change. And, perhaps most importantly, I appreciate that many companies abroad, especially in Europe, face additional challenges in the near term that go above and beyond those faced by U.S. issuers as they adopt international accounting standards for the first time in 2005.

With respect to small, medium sized and less sophisticated businesses, I have encouraged the private sector to develop internal control guidance designed specifically to address their needs. The existing guidance for these companies is sparse, so I am delighted that COSO has indicated a willingness to undertake a project to develop appropriate guidance and to complete their efforts by summer of 2005. I strongly support COSO's efforts. Speaking of COSO, I should also commend them for issuing a new integrated framework which establishes a comprehensive benchmark for enterprise risk management.

While most of our efforts to date have focused on implementation issues, in addition to focusing on the particular needs of foreign private issuers and small business, Alan Beller and I are committed to having an open dialogue with preparers, investors, analysts, auditors and others next spring to consider:

- Best practices.
- What's working.
- What isn't working.
- And how the process can be streamlined to ensure that investors are getting useful and relevant information in a cost effective manner.

I also intend to work closely with other government agencies and the PCAOB as we consider these issues. As I mentioned before, we need a common sense approach to all aspects of financial reporting, and it is important that, in the area of internal control, the focus and resources be directed to the higher risk areas.

As is the case with any major change, there are bound to be challenges along the way, and we should expect in the coming months to see an increasing number of companies announce that they have material weaknesses in their controls. For this

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initial pass, that finding generally should not be surprising. Nor should it, by itself, necessarily be motivation for immediate or severe regulatory or investor reactions. What's important is that material weaknesses are identified and fully disclosed and that management addresses such weaknesses with appropriate remediation efforts. The goal should be continual improvement in controls. Investors will benefit from such disclosures, so I encourage companies who know they have a material weakness to provide a fulsome discussion of these issues and of their remediation plans as soon as practical.

There is no way to measure how many reporting failures may be averted or how many investment dollars may be saved because of the increased attention to stronger internal controls. But we do know that strong controls are vital to high quality financial reporting and essential to timely analysis. All participants in the financial reporting process - investors, management, audit committees, auditors, lawyers, and regulators - can help to achieve the goals of these reporting requirements by making control systems a priority.

XBRL

While we are considering changes in financial disclosures, we are also considering the costs and benefits of adopting new risk management and technology tools. I've said many times that we need to consider changes to financial reporting in the context of better, faster and cheaper ways to produce information for investors. As part of that initiative, the Commission is embracing new technologies that may enable further improvements in these areas. For example, the advent of the internet has enabled investors to access more information faster and cheaper. And, other tools exist, such as data tagging, that can better harness the power of technology. The benefits of such tools are being considered by the public and private sectors around the globe.

In late September, the Commission issued a Concept Release that explores data tagging as a means of improving the financial reporting model for investors. It also explores the specifics of eXtensible Business Reporting Language - XBRL - the only tagging tool we are currently aware of for business reporting content. Additionally, the Commission proposed a rule that would allow registrants to voluntarily furnish XBRL files to the Commission using EDGAR. The Commission is still considering comments we received and no final decision has been made, but I hope that the program will be up-and-running for the 2004 calendar year-end filing season. Though we understand that many of you are consumed in the near term with the internal control requirements, we truly hope that over the next year we get a significant amount of participation. It's important to note that in the proposing release we have done a number of things to encourage participation in the voluntary program, including: providing limited liability relief for XBRL exhibits, the ability to file the information using Form 8-K, the ability to tag only part of a disclosure document, the ability to start and stop and not have to continuously file XBRL exhibits, and there is an easy way to get involved - that is, by calling one of the SEC staff members listed on the first page of the proposed rule. Let me make this even easier, you can call Jeff Naumann who recently joined my office from the AICPA at 202 942 4400.

I encourage you to follow the discussion about the use of tagged data and to provide us with your thoughts. I believe that XBRL has the potential to bring about further improvement to our financial reporting model. Likewise, I am encouraged by the Enhanced Business Reporting Consortium's efforts to develop a voluntary, internationally recognized framework for presenting industry-specific key performance indicators and disclosure of non-financial information about opportunities, risks and management's strategies and plans. And I would like to acknowledge the important role that the AICPA has had and continues to have in this effort. This represents the type of discussion and action that should be occurring in the marketplace as we all seek to improve the value of information for investors.

While I would never be so presumptive as to predict the future of financial reporting, I do believe that continuing to defend the status quo is not the answer, and I am confident that new technologies such as XBRL will play an important role in enabling these changes to take place. I also believe that it is important that the younger generation take a leading role in the broader use of technology. You are the generation of instant messaging, blackberries, and ipods, so you are in the best position to recognize and take advantage of the seemingly endless advances in technology.

International Issues

Finally, I did not save international issues until last because it is the least important. Nothing could be further from the truth. That is why I have asked my recently appointed deputy, Julie Erhardt, to speak to these matters as soon as I finish my remarks. Before she does however, I would like to make a few comments.

I am greatly impressed by the tremendous and positive progress that has been made in the European Union to move to an integrated financial services market and by the efforts in the EU and in other areas around the world to improve the infrastructure that supports high quality financial reporting. And I should also mention the significant progress that has been made to create and improve IFRS. Developing a high quality set of international accounting standards has truly been a monumental task. I would also like to commend the IASB for its efforts to work with standard setters around the world to find solutions to important accounting issues and, in particular, for its cooperation with the FASB to address differences between IFRS and U.S. GAAP.

My personal view is that, if things continue as they have been going, I believe that the SEC ultimately will be able to eliminate its requirements to reconcile IFRS to U.S. GAAP. I assure you that I am eager to embrace IFRS, because I believe investors in the U.S. will benefit and, as the rest of the world moves to IFRS, we will need to keep pace.

Anticipating that investors will embrace IFRS, OCA is considering the steps that need to be taken to allow us to eliminate the reconciliation from IFRS to U.S. GAAP. One such step is to review the quality and consistency of the application of IFRS. While a great many non-U.S. companies register securities with us, currently less than 50 of these registrants use IFRS for their primary financial statements. This will change in 2005 as we expect perhaps as many as five hundred of those filing with us to use IFRS. I recognize that, within Europe, some companies may not fully apply IFRS, but my expectation and hope is that the majority of those companies that file with the Commission will fully comply with IAS, including accounting for derivatives.

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We are gearing up for a review of these filings, which will be available for our review in the second half of 2006, to take advantage of the knowledge that can be gained from studying such a large number of IFRS-based financial statements. As part of the study, we will carefully review what differences exist between U.S. GAAP and IAS, and I will strongly encourage the FASB and the IASB to eliminate many of these differences as quickly as possible. Throughout this process, we will be working with preparers, the IASB, FASB, and other regulators to gather information on the experience and knowledge of those adopting IFRS for their 2005 filings.

Convergence is a two-way street, and I strongly support the IASB and FASB working closely together. Said another way, convergence does not mean just choosing U.S. standards. I expect that the FASB will look to IFRS where appropriate. I view the convergence project as an opportunity to make improvements for the benefit of investors. In converging standards, the standard-setters should always choose the better model. Convergence to the lesser accounting model, what has been referred to as "lowest-common-denominator convergence" or a "rush to the bottom," is not acceptable, and in fact, has not occurred. This is also a great opportunity for the IASB and the FASB to leverage off of each others resources to improve accounting standards on a continuous basis.

Conclusion

For many of you, this may be one of the toughest year ends you will ever have. There are many new requirements such as the internal control requirements and, certainly, the level of scrutiny remains high. In this environment, it's important that you be free to exercise good judgment, without an unreasonable fear of being second guessed. I know you're up to the challenge, and I know we're up to the challenge. For this first time around, we realize that some requirements are new. We will not be unreasonable and expect perfection, but I do expect a total commitment by preparers and auditors to the process, and I would be disappointed if you did not embrace these changes.

As you can gather from my comments and the comments that you will be hearing from my three Deputies and from other members of the SEC staff, we remain in a time of change. And that's likely to continue. Part of my role as Chief Accountant is to help identify and set priorities. In that role, my objective will be to improve the quality, timeliness and usefulness of information provided to investors. I believe we have improved and that we can still do better. Financial reports remain complex and are oftentimes opaque. The quality of the audit can still be enhanced. We have to improve standard setting. Disclosures can be more transparent. We have to more broadly embrace technology. We have to adopt a global view. And, most importantly, we have to recommit to putting the interests of investors first. Improvement is not perfection so, as we continue down this path, I don't want us to get bogged down. Let's make good, lasting changes that demonstrate the pride we have in our profession and that justify the trust placed in us by the millions of people who invest in our markets.

Before I turn the podium over to Julie Erhardt, I would like to thank you one more time for caring about the future of our profession. What you do matters greatly.

http://www.sec.gov/news/speech/spch120604dtn.htm

APRIL 2005

BoardMatters Quarterly

Critical Insights for Today's Audit Committee

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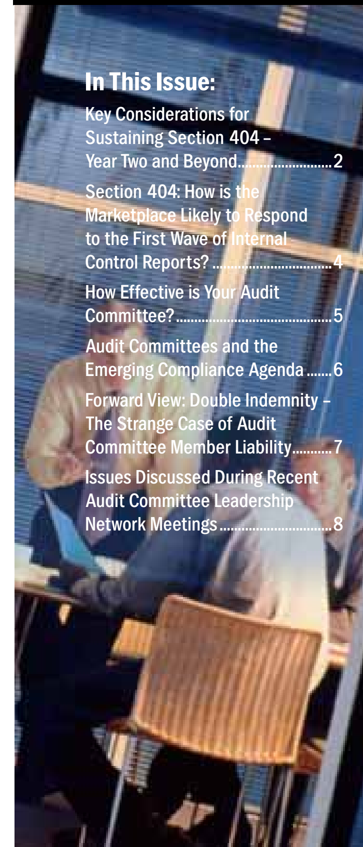
Quality In Everything We Do



A corporate governance survey published in December 2004 by Financial Executives Research Foundation found that 96 percent of public companies surveyed believe their audit committee is effective, but only about two-thirds believe their audit committee members are fully informed of their responsibilities.

In this issue of *BoardMatters Quarterly*, we feature articles on several topics that may be of interest to you and the other members of your board as you continue to clarify your roles and responsibilities and address the issues that company management is dealing with, including:

- *Sustaining Section 404* – Last year's Section 404 implementation project will need to become a sustainable process going forward. Our featured article on page 2 outlines some key considerations your audit committee can contemplate to see that the job gets done.
- *The Market Implications of Section 404 Reports* – Now that companies are beginning to report on their internal controls, including reports of material weaknesses, how is the marketplace likely to respond? The article on page 4 provides Ernst & Young's perspective.
- *Audit Committee Responsibilities* – The article on page 5 provides helpful information as you conduct a self-assessment to determine the effectiveness of your committee. The information on page 6 highlights some things to consider as you work with company management on the emerging compliance agenda.
- *Audit Committee Member Liability* – In the wake of the Sarbanes-Oxley Act, audit committee members certainly have an increased level of responsibility and there is concern about the potential increase in personal liability, particularly for those designated as financial experts. Turn to page 7 for a list of things you can consider to help protect yourself.
- *Audit Committee Leadership Network (ACLN)* – Read page 8 to see some of the issues ACLN members have discussed over the last several months.

Please feel free to contact us with your feedback on this issue of *BoardMatters Quarterly*, or with your ideas for future issues. We encourage you to share this information with your colleagues and ask that you let us know of others who would benefit by receiving this publication. Send your feedback to Lisa Hallman at lisa.hallman@ey.com. ✔

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Key Considerations for Sustaining Section 404 – Year Two and Beyond

The Public Company Accounting Oversight Board's (PCAOB) requirements relating to Section 404 underscore why companies cannot look at last year's effort as a one-time project that has come and gone, and instead must focus on establishing a sustainable process for this and future years. The PCAOB specifies that each year's Section 404 effort to assess the effectiveness of internal control over financial reporting must 'stand on its own.' As a result, the activities that occurred last year will have to be sustained this year, and in subsequent years, to the extent necessary to achieve compliance.

Audit committees need to take an active oversight role in sustaining Section 404 activities and seeing that the job gets done. Key considerations for this oversight in year two and beyond include:

- What is the same—and what is different—for Section 404 after the first year of implementation?
- Is management setting the right tone at the top for control consciousness in the organization? Is timely action being taken to address both pre-existing and new control deficiencies?
- How do changes in the business impact processes and procedures for both Section 302 and Section 404?
- What role does internal audit play in Section 404 sustainability?

What is the same? What is different?

Given that the PCAOB has yet to perform its first inspections of Section 404 audit work, and that the SEC held a roundtable on April 13, 2005 to further discuss the implementation of Section 404, uncertainties exist as to whether the rules may change over time. Looking at Section 404 sustainability based on the standards that exist today, overall requirements and the basic steps to achieve compliance will be the same this year, and on an ongoing basis, as they were in the first year. However, key areas that may need to be reconsidered over time include objectives, scope, and process.

Objectives

For many companies, the objective for Section 404 implementation projects in the first year was primarily focused on meeting the requirements and deadlines set forth in the rules. Moving forward, new objectives are emerging including cost containment, value generation, and integration of new compliance requirements. Key questions to address in determining the company's objectives include:

- How can the 404 process be completed more efficiently? To what extent can Section 404-related activities be embedded into business units and processes?
- What kinds of future improvements in internal control are needed and/or desired? What value can be derived from process improvements?
- How will the 404 work done in 2005 relate to the quarterly 302 certification process and/or other compliance initiatives?

Scope and Process

The scope of Section 404 work in the first year was significant. While the ongoing scope of these efforts should not be as great as the implementation year, the same basic activities will need to be carried out. The overall process—determining significant accounts, disclosures and relevant assertions, identifying significant processes and locations, updating the relevant documentation and testing strategies, and coordinating and monitoring the process—is still necessary.

Several of the factors that must be considered include:

- How is the organization planning to move Section 404 from a project to an ongoing process?
- Who will take responsibility for the ongoing effort?
- How is the company moving to embed responsibility in the business units for day-to-day documentation, testing, and remediation?
- Do the business units clearly understand their responsibilities? Are they adequately staffed with the right skill sets and are they properly trained? Are specialty resources and/or advisors needed to supplement existing resources?

Tone at the Top

The tone set by the top management of an organization influences the control consciousness of its people, and is the foundation for all components of internal control. It also provides discipline and structure. A primary intent of the Sarbanes-Oxley Act was to reinforce that principle and to improve the corporate environment in which financial reporting occurs.

Audit committees have a critical role in promoting a tone that contributes to the integrity of the financial reporting process, and in assessing and monitoring the tone that is set by management throughout the organization. A key indicator of the control environment's tone that audit committees should consider is management's response to and handling of control deficiencies.

Other considerations of tone at the top include:

- Is management committed to maintaining Section 404 compliance as a top priority? Do management communications set the right tone for control consciousness? Do the resources and budget allocated to Section 404 compliance implementation reinforce it as a top priority?
- Are control deficiencies identified in 2004 being addressed? What is the process to inventory and deal with newly identified issues?
- Are human resources policies and practices consistent with a tone that reinforces control consciousness?

Changes in the Business

After the first year of Section 404 reporting, management is required to disclose in each quarterly report any change in internal control over financial reporting that occurred during the last quarter that has materially affected, or is reasonably likely to materially affect, internal control over financial reporting ("material changes in internal control"). The auditor will perform limited procedures each quarter to provide a basis for determining whether material modifications should be made to management's disclosures about material changes in internal control. Any material changes identified in the quarterly certification process will also need to be considered as part of management's Section 404 assessment work.

Some of the questions that immediately present themselves when considering this topic include:

- Is there a process in place to identify changes in the business that could result in material changes in internal control?
- Has materiality been defined and qualitative criteria established to identify a material change in internal control and/or assess the effect of identified deficiencies on interim financial statements?
- Is the disclosure committee appropriately linked into the process to make disclosure decisions?
- Is the external auditor appropriately involved in the process?

The Role of Internal Audit

In most organizations, internal audit is the primary group which has an understanding of the business process, control concepts, and testing methodologies required to complete the 404 process. At the same time, the audit committees of many companies have traditionally relied on their internal audit departments to focus on the non-financial risks that their companies face.

In the initial year of Section 404 implementation, many internal audit functions were challenged to complete their annual audit plan as they provided skilled resources to participate as members of 404 project teams. Moving forward, companies will need to clearly define the role, if any, that internal audit will play in supporting the Section 404 compliance effort. Considerations for internal audit include:

- How will internal audit support the maintenance of 404? Will it assist with regular testing? How will its role impact the work of the external auditor?
- Will the internal audit department be divided, or will the organization create a new function focused on financial reporting risk? If so, how many people will it require? Where will these skill sets be obtained?
- How will the 404 process affect the risk assessment process and audit plan?
- Will audits of third-party providers become more important or more frequent as a part of Section 404 work or as a part of the organization's overall risk management strategy?

Concluding Thoughts

Although there is uncertainty that Section 404 requirements may change over time, audit committee members need to reflect on the implications of Section 404 beyond the first year of implementation and continue to evolve their thinking. Looking at 404 as a sustainable process, and not a one-year project, will require audit committees to ask different questions and consider new responsibilities as an ongoing part of their oversight role. ✔

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Section 404:

How is the Marketplace Likely to Respond to the First Wave of Internal Control Reports?

We are beginning to see the results of the first wave of internal control reporting. Section 404 requires that management and their independent auditor assess and report annually on the effectiveness of the company's internal control over financial reporting. All identified material weaknesses that exist at the company's fiscal year-end must be disclosed in these reports. Now that the marketplace is receiving new information about internal controls, including certain companies that are reporting material weaknesses, how is it likely to respond?

It is impossible to predict with certainty the implications of the new reports to the marketplace. The expectation is that underwriters, analysts, rating agencies, lenders, and other market participants will build consideration of internal control reporting into their decision-making models and evaluation criteria. For companies that report material weaknesses, we believe investors and other financial statement users should carefully evaluate each material weakness to understand its nature, cause, and potential effects on the company's financial statements.

The process of evaluating a material weakness can be complex and often involves many considerations, but it is anticipated that the end result will be that not all material weaknesses will cause the same level of concern in the marketplace. For example, material weaknesses that represent a pervasive deficiency often will cause greater concern than weaknesses that are narrowly confined to a specific account, process, or location. Examples of pervasive material weaknesses could include an ineffective control environment (i.e., overall culture and tone at the top), fraud perpetrated by senior management, or systematic enterprise-wide IT deficiencies. More narrowly confined weaknesses could relate to the accounting for specific types of transactions.

Regardless of the nature of the deficiency, all material weaknesses generally need to be remediated as soon as practicable. Accordingly, a key consideration when evaluating the disclosure of a material weakness should include an understanding of management's plans to remediate the weakness and whether such plans appear reasonable under the circumstances.

In a speech at the 11th Annual Midwestern Financial Reporting Symposium, SEC Chief Accountant Donald Nicolaisen's observations on preliminary reactions from investor groups suggest that he concurs that not all material weaknesses will be viewed with equal significance. Nicolaisen also indicated that he expects a number of companies will announce that they have material weaknesses in their controls and that this finding generally should not be surprising during this first round of reporting.

He does not believe that, by itself, the reporting of a material weakness should necessarily be motivation for immediate or severe regulatory or investor reactions.

Material weaknesses can be related to the restatement of previously issued financial statements. However, it is important to remember that a material weakness does not necessarily mean that a material misstatement has occurred, or will occur, in the financial statements. Rather, it indicates there is a more than remote possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected by the company's internal controls. Even if a material weakness in internal control is disclosed, the auditor could issue an unqualified opinion on the financial statements concluding that the company's existing financial statements are reasonably assured to be free of material misstatement.

As is relates to regulatory considerations, the SEC staff has stated that an adverse opinion on the effectiveness of internal control over financial reporting by management and/or the auditor generally will not, in and of itself, create a regulatory hurdle to raising capital and accessing the capital markets, as long as the independent auditor's report on the audit of the related financial statements is unqualified and all other reporting obligations are current and timely.

The new reporting requirements are likely to result in more timely identification and remediation of weaknesses in internal control over financial reporting as companies build the evaluation of internal control into their everyday processes. The ultimate goal should be more reliable financial reporting and increased investor confidence.

For further information, refer to Perspectives on Internal Control Reporting: A Resource for Financial Market Participants*, a publication developed by Ernst & Young and three other public accounting firms to help financial market participants understand issues related to internal control reports. It is available online at www.s-oxinternalcontrolinfo.com.* ✔

On March 2, 2005, the SEC announced that it was providing Foreign Private Issuers (FPIs) and non-accelerated filers with an extension to comply with the internal control reporting requirements of Section 404 of the Sarbanes-Oxley Act of 2002. The new effective date for internal control reporting—for both management's assessment and the external auditor's attestation—will now be effective beginning with fiscal years ending on or after July 15, 2006 (previously July 15, 2005).

How Effective is Your Audit Committee?

Audit committees play a key role in the oversight of the financial reporting process—even more so with the new internal control reporting requirements. An effective audit committee can contribute to a strong control environment. How effective is your audit committee? Conducting a self-assessment can be a useful tool to find out.

Certain requirements exist for public companies to assess the audit committee. For example, companies listed on the New York Stock Exchange are required to perform an annual evaluation of the audit committee.[1] The importance of an effective audit committee is evident in this requirement because the independent auditor has to consider *ineffective* oversight by the audit committee to be at least a significant deficiency and a strong indicator that a material weakness in internal control over financial reporting exists.[2]

Even if it is not required, a self-assessment of the audit committee can provide useful information for the committee and the board of directors. Self-assessments can help identify areas where the audit committee needs to improve in order to fulfill its oversight objectives.

Once a self-assessment of the audit committee has been performed and results have been determined, important next steps are to develop an action plan and a means to monitor the implementation of the action plan. Any changes in the responsibilities of the audit committee, or in the way that the committee operates, can be reflected in the Audit Committee Charter and/or in the more detailed Audit Committee Meeting Planner. The audit committee's legal advisors also can provide useful advice when the audit committee is performing its self-assessment process and evaluating and documenting the results of that process. ✔

Matters to consider when performing an audit committee self-assessment:

- *Who should be surveyed?* The audit committee may limit its assessment to audit committee members or consider broadening the scope. Some audit committees have found a 360-degree assessment to be helpful, i.e., the board of directors, key management personnel, and the auditors are all surveyed. The surveys for non-audit committee members need to be tailored for each respective type of respondent, to provide valuable feedback as to how well the audit committee is working with others involved in the financial reporting process, and how others perceive the committee's effectiveness.

  In addition, the audit committee could perform evaluations of individual members, including the audit committee chair. Evaluations might include topics such as time commitment to the work of the committee, financial expertise, ability to contribute, willingness to challenge and hold management accountable, diligence, insightfulness, and leadership skills. These evaluations could prove valuable in determining a succession plan for the chair of the committee.

- *What questions should be asked?* Questions should reflect your committee's situation and responsibilities. The questionnaire should at least address the responsibilities outlined in the Audit Committee Charter and in a more detailed Audit Committee Meeting Planner, as applicable.

  Self-assessment tools are available to assist the audit committee, including several from Ernst & Young (available in the Audit Committee Member Toolkit which is accessible through EY *Online* or your client service partner) and the AICPA (available in the AICPA Audit Committee Toolkit).

- *How will effectiveness be determined?* A rating scale can be a useful way to determine the audit committee's effectiveness in its various areas of responsibility. For example, a 1 to 5 rating scale could be used with 1 defined as 'not effective' and 5 defined as 'highly effective.' Providing space for comments also can provide useful feedback when determining the effectiveness of the committee in a particular area.

- *How often should the survey be performed?* An annual self-assessment can provide timely feedback for the committee and also help the committee determine where to focus its efforts during the upcoming year.

[1] NYSE Listed Company Manual Section 303A.

[2] Public Company Accounting Oversight Board Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, paragraph 140.

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Audit Committees and the Emerging Compliance Agenda

Global Convergence of Audit Committee Responsibilities

Global regulatory and market forces are driving an expanded compliance agenda for many audit committees. This expansion is expected to continue as more audit committees assume responsibility for overseeing compliance with multi-jurisdictional laws and regulations. While compliance practices will continue to vary across nations to align with home country legislation and cultures, we are beginning to see a convergence on a global basis. For example, over three quarters of audit committees in the United States are responsible for overseeing corporate compliance and ethics programs, as are over half of their United Kingdom and Western European counterparts.

Oversight of Ethics/Compliance Programs by Audit Committees

Source: *Ethics Programs: The Role of the Board – A Global Study.* The Conference Board, Inc., 2004

Drivers of the Compliance Agenda

Fraud and unethical behavior were at the root of many recent corporate scandals and failures, resulting in a crisis in confidence in many of the global capital markets. In response, new legislation and regulations were enacted to restore trust in the capital markets, and to bring a heightened level of accountability to corporations and their audit committees. Several of the most significant standards facing global organizations today include:

- Sarbanes-Oxley Act of 2002
- 8th Directive on Company Law
- Organisation for Economic Co-operation and Development's (OECD) country legislation
- 2004 Amended U.S. Federal Sentencing Guidelines

The Sarbanes-Oxley Act in the United States and the 8th Directive in the European Union are two of the more high-profile initiatives. They are reaching into global boardrooms holding boards, and audit committees in particular, accountable for compliance and ethical matters at all levels of the organization.

Compliance Program Considerations

Leading practice organizations are becoming more proactive in managing their compliance risks by instituting programs to prevent, detect, and respond to violations of legal regulations and statutory requirements. Such programs promote ethical behavior, both by and within the company. Considerations for effective compliance programs include:

Elements	Key Questions to Consider
Control Environment	Who owns and oversees compliance? Is there a documented code of conduct? Does the organization's structure and cultural environment encourage compliance? How is performance evaluated and rewarded? What fraud prevention mechanisms are in place?
Risk Assessment	Who is involved in the risk assessment process? Are periodic risk assessments conducted? How are key compliance risks identified and measured? How are key risks managed and mitigated?
Control Activities	Are all management, employees, and company agents effectively trained on compliance matters? Are compliance policies and procedures consistently enforced? How are internal investigations conducted? How are outsourced processes controlled and managed?
Information and Communication	How effective is the company's whistleblower system? Has a formal communication plan been implemented for both employees and other agents? Does the IT system support full and timely compliance reporting?
Monitoring	Who is involved in the monitoring process? Are ongoing compliance reviews and periodic audits conducted throughout the organization? Do high risk areas receive greater monitoring attention?

In the end, 'tone at the top' considerations provide the foundation for an effective compliance program. Audit committees play a key role in assessing, promoting, and monitoring the tone at the top and providing oversight to compliance programs. In this new era, it is critical that audit committees recognize that the bar has been raised for legal and regulatory compliance responsibility. As a further incentive, personal interests are at risk if these compliance programs prove ineffective. ✔

Forward View

by Tapestry Networks

Double Indemnity – The Strange Case of Audit Committee Member Liability

"Do I have a bigger target on my back as a member of the audit committee?" That has been the question on the minds of many audit committee chairs during recent meetings. As one chairperson told us, "The concern that some of us have is that there is a tiered level of responsibility for directors."[1]

These questions concerned audit committee chairs long before 11 former WorldCom directors reportedly agreed to pay $20 million out of their won pockets as part of a settlement with shareholders.[2]

Commenting on the case in the *Financial Times*, three eminent law professors wrote, "The lead plaintiffs... were public pension funds… But because public pension funds are accountable to political officials, there is always the concern that their governance positions may be compromised by politics… If making outside directors pay proves to be good politics, more settlements can be expected, regardless of the governance merits."[3]

In the wake of the Sarbanes-Oxley Act, audit committee members certainly have an increased level of responsibility and there is concern about the potential increase in personal liability, particularly for those audit committee members designated as 'financial experts.' In response, the SEC introduced a liability safe harbor provision in its rules, reassuring audit committee financial experts that such a designation "does not enhance the duties, obligations or liabilities faced by such experts."[4]

Nonetheless, directors are concerned about recent precedents in state law. In the 2004 case *In re Emerging Communications, Inc. Shareholders Litigation* in the Delaware Chancery Court, a director was found jointly liable for $77 million when he was deemed to have breached his fiduciary duty because the court said his expertise, due to his background in the industry and as an investment adviser, meant that he should have known that the price of a transaction was unfair to minority stockholders. One attorney told us that this case might be used to assert that many audit committee members also have this type of specialized financial expertise.

So what can audit committee members consider to assist in protecting themselves? One director, who is also a practicing attorney, recently told us that he had sought a personal liability insurance umbrella policy for protection. However, he was denied coverage due to the perception of increased risk represented by his role as an audit committee chair of a public company.

Attorneys suggest that audit committee members contemplate the following steps so they do not needlessly take on added liability:

- Limit the number of audit committees on which they serve.
- Check that the company's D&O policies offer good and broad coverage.
- Inspect the committee charters and bylaws to check that they have the correct exculpatory provisions.
- Seek a formal indemnification agreement with the company.

Formal indemnification agreements represent an emerging trend among directors and provide funding for the costs of litigation and investigation. If audit committee members feel they have a bigger target on their back, will boards be prepared to offer such agreements to protect them? ✔

Forward View is written by Tapestry Networks. Ernst & Young works with Tapestry Networks to orchestrate private dialogues, including the Audit Committee Leadership Network (ACLN), and to develop practical insights and solutions to help enhance the functioning of financial markets. The ACLN is a group of audit committee chairs from some of America's leading companies.

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[1] Reported in Audit Committee Leadership Network, *ViewPoints*, "Shared responsibility: the audit committee and the board," December 20, 2004.
[2] Gretchen Morgenson, *The New York Times*, "Ex-Directors at WorldCom Settle Anew," March 19, 2005.
[3] Bernard Black, Brian Cheffins, and Michael Klausner, *Financial Times*, "Why directors' damages may harm investors," January 21, 2005.
[4] Chad Conwell, *ClientAlert*, "Increased Liability for Audit Committee Financial Experts?" Paul, Hastings, Janofsky & Walker, LLP, June 2003.

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Issues Discussed During Recent Audit Committee Leadership Network Meetings

As audit committees continue to expand their capabilities, the Audit Committee Leadership Network (ACLN) and the Audit Committee Networks (ACN) share insight, identify emerging best practices, and offer peer support to audit committee chairs and members.

During its December 2004 meeting, the ACLN focused on the shared accountability between boards and their audit committees. Network members exchanged numerous ideas for enhancing the relationship between the two constituents, such as six tips for improving shared responsibility (see sidebar). Other discussion items included managing time constraints around agenda items, approaches for enhancing interaction across committees, and the benefits of sharing information between meetings.

A recent ACN meeting focused on the changing face of the audit committee and the impact this variable role has on committee composition and performance. Members shared techniques on defining the roles around regulatory compliance, committee views on enterprise risk management, and the impact on tomorrow's organization.

In tandem, the committees remain close to issues surrounding Section 404, including controlling costs, resource challenges, and overall planning and reporting for year two and beyond.

To learn more about the networks and to read summaries of their discussions, go to eyonline.com/auditcommittee and click on the Audit Committee Leadership Network tab. ✔

These networks are convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and to share insights into issues that dominate the new audit environment.

Six Tips for Improving Shared Responsibility

1. Clearly articulate to the governance committee and the full board what topics the audit committee will cover, their implications for the board, and when the audit committee will report on them.
2. Schedule board committees' meetings before the full board meets in order to provide real-time summaries of what they have just decided.
3. Add the audit committee agenda to the board book, together with supporting documents for key items raised at the committee meeting, so that all directors see them before any board discussion.
4. Add approval of the audit committee minutes to the agenda for the next board meeting and use this as an opportunity to ask if directors want to dig deeper into issues that may have been discussed only briefly in the audit committee report the first time around.
5. Involve the audit committee chair in developing a syllabus for ongoing education for the full board that would incorporate audit committee topics such as accounting policies.
6. Systematically rotate directors across committees to broaden their knowledge and experience.

For more information, go to
eyonline.com/auditcommittee

JULY 2005

BoardMatters Quarterly®

Critical Insights for Today's Audit Committee

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In this issue of *BoardMatters Quarterly*, we feature articles on several topics that may be of interest to you and the other members of your board, including:

- *The Audit Committee's Role in Preventing Fraud* – Our feature story on page 2 explores part of the audit committee's oversight function—considering the risk of management override of controls and how to deter senior management from committing fraud. Committee members may be grappling with this and other fraud prevention-related matters.
- *Section 404: Additional Implementation Guidance Issued by the SEC and the PCAOB* – In mid-May, both the SEC and the PCAOB staffs published additional guidance on the implementation of the internal control reporting requirements of Section 404. The additional guidance was in response to questions and concerns raised at the Roundtable on Implementation of Internal Control Reporting Provisions, hosted by the SEC on April 13, 2005. The article on page 4 highlights some of the key topics addressed in the SEC and PCAOB guidance.
- *Realizing the Compliance Potential of the Enterprise Resource Planning Investment* – Most companies implemented an ERP system to either automate business processes for increased efficiency or to address legacy systems' non-compliance with Y2K. Now they are interested in utilizing the control and compliance capabilities within their system for a variety of reasons. Turn to page 5 for the audit committee perspective.
- *Maintaining Auditor Independence* – It has sometimes been thought that independence is entirely the auditor's responsibility. In fact, as explained in the article on page 6, public companies and their auditors have a shared responsibility to ensure the auditor remains independent.
- *Finding the White Space for Audit Committee Priorities* – Many committees believe they do not spend enough time addressing the important issues that they should. The article on page 7 discusses ways to find more 'white space' to help with this problem.

Please feel free to contact us with your feedback on this issue of *BoardMatters Quarterly*, or with your ideas for future issues. We encourage you to share this information with your colleagues and ask that you let us know of others who would benefit by receiving this publication. Send your feedback to Lisa Hallman at lisa.hallman@ey.com. ✔

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The Audit Committee's Role in Preventing Fraud

Recently, audit committees have been heavily focused on overseeing management efforts to comply with Section 404 of the Sarbanes-Oxley Act. In the first year of Section 404 implementation, roughly 90% of public companies (accelerated filers) reported effective internal control over financial reporting. While internal control is critically important in preventing and deterring the *opportunity* for material financial statement fraud, it is worth noting that the risk of fraud through management *override of controls* exists at every entity, even when internal control over financial reporting is considered to be effective. In addition, a review of material financial statement frauds disclosed over the past two decades indicates that such frauds typically involved members of senior management.

These facts cannot be taken lightly by today's audit committees.

Part of the audit committee's oversight function includes considering the risk of management override of controls and how senior management might be deterred from committing fraud. For instance, how can the audit committee help reduce incentives and pressures that might compel a senior officer (e.g., CEO or CFO) to manipulate accounting results? Many audit committee members grapple with this and other questions related to fraud prevention and the committee's oversight role.

In early 2005, the AICPA Antifraud Programs and Controls Task Force issued a document entitled "Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention – The Audit Committee and Oversight of Financial Reporting." This document (available at www.aicpa.org) offers guidance to audit committees in addressing the risk of fraud through management override of controls and provides several recommended actions. Following is a summary of some of the key points to consider related to the AICPA's recommended actions.

Maintaining an Appropriate Level of Skepticism

Audit committees should be independent of management and this independence includes having an 'appropriate level of skepticism.' This requires all audit committee members to ask difficult questions of themselves and of management, fostering an environment of open and candid discussions.

When considering the risk of management override of controls, the audit committee should set aside any beliefs about the integrity of management. The override of controls is most often committed by 'good executives gone bad,' rather than by consistently dishonest people. Any pre-conceived notions about the integrity of senior management can potentially blind an audit committee from seeing warning signals that indicate management may have overridden controls.

The bottom line—financial statement fraud can occur at any entity. Recognizing this fact is the audit committee's critical first step in developing the appropriate level of skepticism necessary to address the risk of management override.

Strengthening the Audit Committee's Understanding of the Business

While many audit committee members may feel they have a good understanding of the business, they should not overlook the importance of continually updating and otherwise strengthening their knowledge of the business and the financial reporting environment. A solid understanding of the company's industry and business is essential to identifying and understanding business and financial risks that may increase the likelihood of fraud.

Understanding the nature of the entity's core lines of business and management's compensation package may help the audit committee to identify incentives and opportunities for fraud. For example, when management's compensation is largely tied to a specific financial performance metric, management may be motivated to manipulate results to achieve that metric. When the audit committee is aware of these potential risk factors, they are better equipped to address the risk of management override.

To identify potential fraud risks, the audit committee must also understand the financial reporting environment (e.g., attitudes, motives, and pressures) affecting those who are involved in the entity's financial reporting, including the CEO and CFO. For example, unrealistic performance expectations, real or perceived, have often been a catalyst for financial statement fraud at business units.

Brainstorming to Identify Fraud Risks

Professional auditing standards require independent auditors to engage in a brainstorming team discussion to consider how and where an entity's financial statements might be susceptible to fraud and how management could perpetrate and conceal fraudulent financial reporting. As part of the audit committee's oversight role, a similar discussion among committee members can be invaluable in sharing ideas about how and where fraud through management override of controls could occur.

The brainstorming session should include considerations from discussions with members of management and others, such as internal auditors, general counsel, and the external auditors. In addition, the audit committee should understand common fraud schemes perpetrated at other organizations (especially within similar industries) and how these schemes might be perpetrated within the company.

This session should be an open forum for members to exchange ideas and consider known internal and external factors affecting the company that might:

- Create incentives or pressures for management and others to commit fraud.
- Provide the opportunity for fraud to be perpetrated.
- Indicate a culture or environment that enables management to rationalize committing fraud (for example, by intentionally using bias to manipulate accounting estimates to achieve earnings goals).

Using the Code of Conduct to Assess the Financial Reporting Culture

The audit committee can use the company's code of conduct to assess the financial reporting culture and tone at the top. However, the mere existence of a code of conduct by itself is not sufficient to mitigate the risk of management override of controls.

The audit committee should understand the details of the code of conduct and assess management's commitment to upholding the code. Members should also consider the extent to which management follows the code, motivates employees to comply with the code, and institutes appropriate disciplinary action for code violations. These actions, as well as the overall tone at the top represented within the code, provide valuable information about the culture and ethical behavior within the company.

When the audit committee is unsure how the code of conduct is perceived within the company or complied with by employees, they should seek feedback from personnel (e.g., obtain results of employee surveys) about their awareness of the code and their assessment of management's support and communication of the code.

Cultivating a Vigorous Whistleblower Program

A leading method of fraud detection includes anonymous tips from employees and other sources. While the Sarbanes-Oxley Act requires that audit committees establish procedures for the confidential, anonymous submission by *employees* of concerns regarding questionable accounting or auditing matters (e.g., a whistleblower hotline), some fraud experts believe that expanding such a program to others (e.g., customers, suppliers, other parties) can increase the information provided to the company and enhance the potential for fraud detection.

Successful whistleblowing procedures require strong leadership from the audit committee. The committee can assist in creating strong antifraud controls by encouraging a culture in which employees view whistleblowing as a valuable contribution to an attractive workplace of integrity. For the audit committee to effectively monitor the risk of management override, the automatic and direct submission to the committee of all complaints involving senior management is essential. The audit committee's primary focus should be on those complaints related to internal controls, accounting, and auditing.

Develop a Broad Information and Feedback Network

Identifying situations where management has overridden internal controls is difficult because those actions typically are not obvious and are not expected of a trusted management team. To increase the committee's ability to detect management override, the committee should consider developing a broad and extensive information network that extends beyond senior management to the internal auditors, the external auditors, key employees, and other board members serving on different committees. By establishing regular meetings and communications with these sources to discuss such items as significant estimates, fraud risks, and any items of concern related to financial reporting, the committee may be able to better identify information that may signal that management override of controls is present. ✔

All audit committees should consider the risk of management override of controls, regardless of the committee's views about management's integrity or the results of management's Section 404 assessment of the effectiveness of internal control over financial reporting. The actions discussed here (and recommended by the AICPA) are a sample of leading practices audit committees should consider to strengthen their procedures for monitoring the risk of fraud through management override.

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Section 404:

Additional Implementation Guidance Issued by the SEC and the PCAOB

On May 16, 2005, the Public Company Accounting Oversight Board (PCAOB) published guidance for auditors on the implementation of Auditing Standard No. 2 (AS2). Concurrently, the Securities and Exchange Commission (SEC) released a statement to issuers on certain matters raised in the implementation of Section 404 of the Sarbanes-Oxley Act. The guidance issued to both auditors and issuers was largely in response to questions and concerns raised at the Roundtable on Implementation of Internal Control Reporting Provisions, hosted by the SEC on April 13, 2005. This article highlights some of the key topics addressed in the guidance.

SEC Staff Statement

Section 404 requires management to assess whether the company's internal control over financial reporting is effective in providing reasonable assurance regarding the reliability of financial reporting. In their statement, the SEC staff pointed out that 'reasonable assurance,' defined as a high level of assurance, is attainable through a 'zone of reasonable conduct by issuers' in the implementation of Section 404. This flexibility in the performance of issuers was augmented by the SEC's advocacy of a top-down, risk-based approach to management's assessment. Ultimately, the SEC staff believes that such an approach will encourage management to devote greater attention and resources to areas of greater risk.

Accounts should be identified as significant giving consideration to both quantitative and qualitative factors, and management has the flexibility to adjust the nature, timing, and extent of the testing of controls in reaching their conclusion of reasonable assurance. The SEC staff believes that requisite skills, training, and the use of judgment are essential to making reasonable assessments.

The SEC acknowledged the extensive judgment that must be brought to bear by management and the auditors in their evaluation of the significance of control deficiencies. AS 2 indicates that a restatement of previously issued financial statements is a strong indicator of a material weakness. However, the SEC explicitly stated that there is no requirement that a material weakness in internal control over financial reporting must be found to exist in every case of restatement resulting from an error.

The SEC staff also acknowledged the role of judgment in management's decision to identify and test only those IT general controls that are relevant to financial reporting for purposes of the Section 404 assessment. Further, the staff recognized the significant benefit to investors when management and auditors engage in dialogue regarding accounting and auditing issues. They do not believe that such dialogue by itself is indicative of a deficiency in internal control over financial reporting.

PCAOB Policy Statement and Questions & Answers (Q&A)

The PCAOB's guidance included a policy statement and a series of staff Q&A. The information primarily focused on the scope of the internal control audit and how much testing of a company's internal control over financial reporting is required. The policy statement summarized the themes of the Q&A and expressed the PCAOB's intentions for administering AS 2 through its inspection and other activities related to the oversight of registered public accounting firms.

PCAOB Statement

Similar to the SEC, the PCAOB advocated a top-down approach to conducting an audit of internal control over financial reporting and a risk-based approach that encourages sufficient focus by auditors on higher risk areas. The PCAOB also encouraged a fully integrated audit in the coming year so that evidence gathered and tests conducted in the context of either audit contribute to the completion of both audits—effectively and cost efficiently. Finally, like the SEC staff in its statement, the PCAOB expressed concern over hesitancy on the part of auditors to provide guidance to clients on accounting and auditing issues for fear of compromising independence or being indicative of a material weakness in their client's system of internal control.

PCAOB Staff Questions & Answers

The Q&A addressed a number of topics, such as:

- Using a top-down, risk-based audit approach
- Identification of significant accounts and key controls
- How the assessment of risk affects the nature, timing, and extent of testing controls
- Benchmarking application controls and alternating tests of controls
- Management's reliance on monitoring controls and self-assessment processes
- Evaluating the adequacy of the extent of management's assessment process
- Timing of tests of controls
- Evaluating the effects of significant changes to IT
- The absence of documentation evidencing the performance of a control
- Principal evidence

For additional information, including Ernst & Young's views on the guidance, refer to our client summary entitled "Section 404-Recent Developments: PCAOB and SEC Issue Additional Implementation Guidance Related to Internal Control Reporting Requirements." You can view this online at eyonline.com/audit-committee (under the E&Y Publications tab). ✔

Realizing the Compliance Potential of the Enterprise Resource Planning Investment

Most companies implemented their Enterprise Resource Planning (ERP) system to either automate business processes for increased efficiency or to address legacy systems' non-compliance with Y2K. Having recently faced the significant effort to comply with the internal control documentation and testing requirements dictated by Section 404 of the Sarbanes-Oxley Act, companies have become increasingly interested in how they can utilize the control and compliance capabilities within their ERP system and balance the need for efficiency and compliance through controls automation within the ERP system.

Linking ERP and the Controls Environment

ERP applications help manage the internal reporting of financial performance to management and the day-to-day information flow across an organization. These systems not only provide a robust platform for automating core business processes, but also for automating the necessary application controls and segregation of duties required for Section 404 compliance. Recent studies have shown that in many large companies as much as 85% of the key financial reporting controls relied upon by management are manual in nature. By effectively integrating the controls functionality that resides within core ERP systems, companies can help build a sustainable controls environment which allows them to better manage the evolving regulatory landscape, while reducing the costs associated with compliance.

Controlled Systems Begin with Good Planning

In response to the cost of compliance, many companies are re-examining their ERP systems to determine which controls they can automate. ERP software vendors are responding to their customers' needs for better controls by developing new modules and upgrades to existing modules which provide additional controls and compliance capabilities. In many cases, these changes will result in upgrades to existing ERP systems or selection of new ERP systems.

- *70% of companies will replace ERP systems or add/upgrade new systems in 2005*
- *66% of companies will add new modules to current ERP systems in 2005*

2005 Corporate Executive Board

The increased focus on using ERP systems to automate compliance has resulted in the introduction of new types of software designed to automate the identification of some control weaknesses, automate the management of segregation of duties and security, and provide capabilities for monitoring the overall control environment.

ERP software vendors, including SAP, Oracle, and PeopleSoft (now part of Oracle Corporation), have developed capabilities for monitoring the controls and transactions within their own systems. Third-party vendors have also developed software products to provide controls and configuration analysis capabilities, as well as transaction and controls monitoring capabilities. Some of these third-party tools are designed to work across ERP systems, which can be beneficial to organizations with multiple ERP vendor solutions.

Before making a decision to buy or upgrade an ERP system and implement new control functionality, an organization should have a good understanding of how configuring new controls will affect its existing system and it should develop a comprehensive plan for managing the changes affecting its ERP.

Evolving Controls Automation and Monitoring

Looking ahead, companies will require more frequent and reliable indication that controls in their ERP systems are operating effectively. Sophisticated analytic tools that embed audit best practices in the core business processes will provide rapid notification of anomalies and control risks when they occur, and opportunities to mitigate those control risks. The overall goal of these real-time systems is to enhance management's insight into control weaknesses as they arise.

Continuous controls monitoring (CCM) is the term associated with leveraging technology to monitor transaction flow through the ERP system and to manage the effectiveness of IT controls. CCM offers companies the ongoing ability to identify control risks and detect control weaknesses. ✔

What Audit Committees Should Know

- Understand the mix of controls (automated vs. manual) relied upon by management and the extent to which automated ERP control capabilities are being utilized.
- Understand IT General Controls environment which is critical to restricting access to applications that support financial reporting.
- Determine whether there are plans to implement third-party or ERP vendor-provided controls monitoring applications and understand how management intends to utilize the output. Understand if the company's information systems plan includes the implementation of CCM capabilities.
- If the company is upgrading or replacing its ERP system, determine whether requirements for automated controls have been properly identified and evaluated against the company's ERP plans.

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Maintaining Auditor Independence

All public companies and their audit committees have a responsibility under the securities laws to retain an independent accountant. The recent focus on auditor independence matters and the auditor independence rule changes of the past few years, including the rules adopted by the SEC on November 15, 2000, the additional and revised rules effective May 6, 2003, and the SEC rulemaking mandated by the Sarbanes-Oxley Act, have heightened awareness of the responsibility of public companies to have an independent accountant. They have also emphasized the shared responsibility with their outside auditors to be independent from one another.

Despite this requirement in the laws, it has sometimes been thought that compliance is entirely the auditor's responsibility. In fact, this responsibility is shared by a public company and its external auditors. This shared responsibility was very recently addressed by the SEC's Office of the Chief Accountant:

> "Public companies have a responsibility to ensure that the auditors of the financial statements are independent. Regulation S-X sets forth the form and content of and requirements for financial statements required to be filed with the Commission. Ensuring auditor independence is as important a requirement as ensuring that revenues and expenses are properly reported and classified. Management, the Board of Directors and the Board's Audit Committee have a shared responsibility to ensure that the auditors of the company's financial statements are independent. If the auditor's independence is impaired then the company has not satisfied the requirement to file financial statements audited by an independent accountant. Discovery of an independence issue at the last minute can adversely affect an otherwise timely filing and can be financially detrimental to the company. There is not only the possibility of having to have the financial statements re-audited but also of an adverse market reaction to the non-compliance with Regulation S-X. **A company should have policies and procedures in place to ensure its auditor is and remains independent. Ensuring auditor independence is a responsibility of both the auditor and the company** [emphasis added]**.** The 2003 Rules place a direct responsibility on audit committees to oversee the auditor's independence. When independence questions are raised with the staff, we often ask about the audit committee's investigation, their analysis of the facts and circumstances and their conclusions as to the audit firm's independence." [1]

Following are a few areas that companies and their audit committees should keep in mind regarding auditor independence. This does *not* cover all areas of auditor independence.

Business Relationships

It is a violation of the SEC auditor independence rules for an auditor to have either a direct business relationship or a material indirect business relationship with its public audit client, except when the auditor is a 'consumer in the ordinary course of business.' This rule extends to the officers, board members, and significant shareholders of the audit client. Business relationships are broadly defined as formal or informal arrangements for services or products provided to the audit firm by an individual or company such as a vendor, consultant, facilitator, sub-contractor, independent contractor, licensor, licensee, reseller, or distributor.

Prohibited *direct* business relationships can come in many forms, including joint ventures or alliances, joint enterprises, or joint products; cooperative arrangements, co-marketing, and certain sponsorship arrangements; providing services jointly to customers under a common contract; exclusive referral arrangements; and borrowing or lending arrangements.

Prohibited *indirect* business relationships could include certain co-investing activities, as well as business arrangements between an auditor and a company that have a significant shareholder who is an officer or director of a public audit client.

As mentioned above, business relationships are only permitted under the SEC's business relationships rules if they meet the limited exemption of the audit firm being a 'consumer in the ordinary course of business.' This requires that the auditor actually *consume* the goods or services it purchases from its audit client and that it do so 'in the ordinary course,' which means, among other things, that the purchase occurs on an arm's-length basis at prices and terms received by comparable customers.

Audit and Non-Audit Services

As a requirement mandated by Sarbanes-Oxley, all audit and non-audit services must be pre-approved by the audit committee of the public audit client. Companies should make certain that operations in remote locations (particularly in foreign countries) or separate entities that consolidate with the parent for accounting purposes understand that pre-approval is required for all audit and non-audit services provided by the audit firm, regardless of the size of the engagement.

The pricing of services for both audit and non-audit services provided by an auditor to its audit client must follow specific guidelines. For example, no contingent fee arrangements can

[1] Comments of Mr. Edmund W. Bailey, Senior Assistant Chief Accountant, Office of the Chief Accountant, U.S. Securities and Exchange Commission, at the AICPA National Conference on Current SEC and PCAOB Developments, December 6, 2004.

Forward View

by Tapestry Networks

Committee Leadership – Finding the White Space for Audit Committee Priorities

Remember the line from the movie "The Life of Brian," "What have the Romans ever done for us?" It sometimes feels the same with Sarbanes-Oxley.

"What has Sarbanes-Oxley ever done for us?" asks audit committee chairs.

The lengthy reply inevitably starts with a litany of complaints including increasing the number and length of audit committee meetings, changing the nature of what is discussed in those meetings, and the potentially increased liability of audit committee chairs and members for those very same topics. It is certainly not the "Life of Riley."

Ironically, audit committees were originally developed to be a time management tool for the board. Now they appear to be running out of time themselves.

Late last year, we revealed that since the passage of the Sarbanes-Oxley Act, audit committee meetings have grown longer and more frequent. Many members reported attending an average of 18 hours of audit committee meetings over the course of a typical year.[1]

Audit committee chairpersons are concerned that much of this extra time is being spent on lower value, check-the-box compliance matters, rather than on the broader questions facing the business such as risk, transactions, or even the organizational structure and long-term missions of the finance and internal audit functions.

Is this time spent on compliance activity actually useful? One chairperson thinks not and he has some interesting solutions. Speaking at the FORTUNE Boardroom Forum in New York earlier this year, Mr. Roland Hernandez, a member of the Audit Committee Leadership Network and chair of the audit committees of Wal-Mart Stores and MGM Mirage, and a member of the audit committees of Ryland Homes and Vail Resorts, urged audit committee chairs to set the agenda for the committee and not allow the general counsel, company secretary, or chief audit executive to determine what is discussed and for how long. He told participants in a workshop dedicated to the activist audit committee, "The audit committee chair needs to be a strong leader and set the agenda."[2] Mr. Hernandez urged chairpersons to limit the number of presentations that focus on checklists and set out the topics that should be covered in depth.

How can the audit committee chair create more 'white space' for strategic discussions in the audit committee? One method is to take as many compliance-related matters out of the meeting as possible and deal with them through pre-reading. According to a recent report from the National Association of Corporate Directors' Blue Ribbon Commission on Board Leadership, "Comprehensive advance materials will eliminate the need for lengthy presentations. Instead, a quick executive summary can be provided, leaving more time for discussion."[3]

Mr. Hernandez recommended that audit committees set a 12-month agenda based on items that come up regularly, like reviewing the 10-Q. These regular items can then be reviewed by committee members in advance of the meeting, leaving room on the agenda for more strategic issues. The audit committee chair should select two to three deep-dive presentations for each audit committee meeting.

[1] Audit Committee Leadership Network in North America, "Audit committee agendas," *Insights*, October 29, 2004, 3.
[2] Tapestry Networks, "Call-For-Activism workshop for the audit committee," *Viewpoints*, March 8-9, 2005, 5.
[3] National Association of Corporate Directors, "Report of the Blue Ribbon Commission on Board Leadership," October 2004, 30.

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SCORE Retrieval File
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Maintaining Auditor Independence

exist between a public company and its external auditor for audit and non-audit services rendered. These guidelines were recently reinforced by the Chief Accountant of the SEC. All individuals within a company responsible for procuring services from the outside auditor should understand the restrictions concerning the pricing of the auditor's services.

Hiring Procedures

An often overlooked requirement of Sarbanes-Oxley, but one that is critical with respect to the maintenance of auditor independence, relates to the hiring of auditor personnel by the public audit client. Sarbanes-Oxley contains a 'cooling off period' requirement. It provides that a member of the audit engagement team may not join an audit client in a financial reporting oversight role during the one-year period preceding the date of the commencement of audit procedures.

These rules are complex and require case-specific analysis; it is possible that the cooling off period can extend for up to two years for a given individual. Thus, it is imperative that client personnel involved in the recruiting process understand that the hiring of an audit team member (regardless of rank) may have serious consequences with respect to the auditor's independence.

Similarly, auditor independence implications are raised by the employment of a person (including board and audit committee members) who is a close relative of a member of the company's audit firm. Such situations require careful analysis, based upon the facts and circumstances. Consultation with the audit firm and general counsel is absolutely critical if such employment situations arise.

If you have questions on auditor independence, Ernst & Young personnel can assist in answering your questions. ✔

Committee Leadership: Finding the White Space for Audit Committee Priorities

Even if white space is created, how should the audit committee chair prioritize the myriad of topics that could end up on the audit committee's agenda? Mr. Hernandez uses criteria from an enterprise-wide risk management process, such as the size of the risk involved, the ability to take a process-oriented perspective, and materiality.

Mr. Hernandez's view is that historically, audit committees looked at actions and transactions over the financial quarter, such as changes in the income statement and individual defalcations. He told FORTUNE Boardroom Forum participants, "[In the past,] we didn't ask as much about the process or organizational issues behind them – what is happening that leads to bad transactions."

According to online encyclopedia, *Wikipedia*, "A page crammed full of text or graphics with very little white space runs the risk of appearing busy, cluttered, and may be difficult to read." Perhaps audit committee members faced with no white space for important discussions on the business of the business feel the same way. ✔

Forward View is written by Tapestry Networks. Ernst & Young works with Tapestry Networks to orchestrate private dialogues, including the Audit Committee Leadership Network (ACLN), and to develop practical insights and solutions to help enhance the functioning of financial markets. The ACLN is a group of audit committee chairs from some of America's leading companies.

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